The outlook for income investing – challenges and opportunities

Drawing a sustainable income from your assets, whilst also enjoying growth in your portfolio's capital over time, has historically been a relatively achievable investment goal. However, if the past few years have been a bitter pill to swallow for income-seeking investors, then 2020 has served as a rather unwelcome cherry on top.

The economic crash in March 2020 spawned the most extreme cuts to global dividends in history. In this unparalleled environment, many businesses were placed under intense regulatory and political pressure to abort their payouts to shareholders. Fortunately for investors reliant on an income from their portfolios, we believe there are more palatable times ahead.

Changing investor preferences have penalised dividend-paying stocks

Since early 2018, significant shifts in investor preferences has meant that the prices of high-yielding shares have struggled to keep pace with other segments of the stock market.

This is at least partly because investors have been very willing to pay handsomely for shares in 'growth' businesses in a low-growth world. 'Growth' businesses are those deemed to have greater predictability in their earnings (such as consumer staples) or greater potential for future growth (often technology businesses), and they rarely return cash to shareholders in the form of dividend payments.

At the other end of the spectrum, shares in 'value' companies (often telecommunications, utilities, energy and financial businesses) are much more likely to offer high dividend payouts, but have been comparatively unloved by investors. This lack of interest has held back the market price of 'value' shares, while those of 'growth' businesses have soared. In addition, Brexit-related fatigue among international investors has impacted the traditionally high-dividend-paying UK stock market, further penalising the assets held by income investors.

Bond markets have faced challenges of their own

Meanwhile in mainstream bond markets, yields have been pushing lower, with investors needing little incentive to invest in these traditional income sources. In turn, traditional bonds have therefore offered exceptionally good capital gains for those already invested, but present a rather lacklustre prospect for income seekers looking to invest.

Compounding the struggles of income investors in bond markets, a vast global wave of negative-yielding debt (where investors effectively pay to lend out their money if they hold such bonds to maturity) reached record-breaking levels of around $17 trillion in 2019. This raises serious questions about the future income prospects of bond-based portfolios.

Will 2021 witness the return of dividend payments?

In the face of significant pressure, even companies very much able to fund their pre-existing dividend commitments were strong-armed (explicitly or implicitly) into holding them back during the pandemic crisis. This was especially true of banks, whose balance sheets have improved greatly since the global financial crisis more than a decade ago. Despite most banks now generating sufficient cash flows to cover dividend payments comfortably, global regulators compelled them to suspend dividend payments, prioritising the needs of local economies over shareholders.

However, notwithstanding another big economic shock, we do expect dividend payments to resume in the relatively near future, creating a pickup in income flows. Since so many businesses were in a position to pay their dividends even in 2020, the dividend picture has the potential to be much better in 2021. Company earnings news in the first few months of 2021 will be closely watched.

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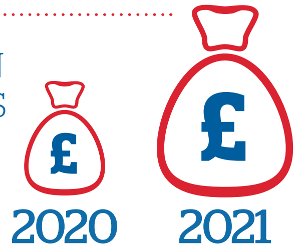

Uncovering income opportunities will require flexibility and selectivity

But even as we prepare to enter what will hopefully be a much better period for investors reliant on drawing an income from their portfolio, a selective approach will remain key. For one thing, a number of big dividend payers, particularly in the traditional energy sector, had been overpaying their dividends for some time, in some cases borrowing funds (by issuing debt) in order to maintain dividend payouts to shareholders. This was unsustainable, particularly given lower oil prices and a need to reinvest in their businesses to position for greener energy. In the aftermath of the economic and stock market fall, a number of notable companies in this sector did take action, resetting dividend policies to much lower levels.

Further, while dividend payments will broadly return in most instances, the other challenges facing income investors (outlined at the outset of this article) have not evaporated. We believe that investors looking for income in 2021 will need all the flexibility they can get. This makes a truly multi asset approach – focused on sustainable income, portfolio growth and capital protection – more valid than ever.

Income managers need to be more creative than ever before

We think that a multi asset approach means not only being creative with traditional income-providing asset types like bonds and dividend-paying shares, but also looking to alternative sources of income elsewhere in the vast investment universe. Within our own portfolios, in specific areas like healthcare royalties and infrastructure project debt, robust underlying business models have allowed dividends to be delivered to investors as expected, despite the economic shock. The range of products available to income managers is expanding, giving those with a multi asset remit greater freedom and flexibility to create more balanced portfolios.

Put simply, as we look to the future for income investing, an investment approach that includes as many asset types as possible, will allow managers much more room to manoeuvre than a single asset approach (e.g. a portfolio focused solely on bonds or shares). Most importantly, this flexibility has the potential to serve income investors well across a range of financial market conditions.

Can a multi asset approach help to manage risk for income investors?

Income investors have to face risks on multiple fronts, not only securing an appropriate level of income, but also managing wider factors like volatility in their income stream and inflation (the real value of income could fall as the cost of living rises).

Another key consideration is the risk to the investment capital itself: if the core capital of a portfolio is damaged, then it becomes more challenging to generate a robust level of income, no matter how sound your investment decisions thereafter.

In building an income-oriented total return solution, multi asset investors have the ability to deploy traditional investments alongside a diverse range of other specialist and alternative holdings. With the flexibility to switch between asset types and geographies, this can help to smooth the journey for income-seeking investors.

In combatting such a broad range of risks to both income and capital, though, diversification is crucial. Spreading the opportunity of reward and the possibility of loss is key to many investment styles, but arguably it is nowhere more important than in investing for income.

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>
> Jaisal Pastakia, Investment Manager

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Wealth Briefing European Awards 2019

Winner: Best Fund Manager

Winner: Change Management Process/Best Implementation of a Technology Solution

Shortlisted: Most Promising New Entrant (Sustainable)

Financial Services Forum Innovation Awards 2019

Winner: Customer Loyalty

Highly Commended: Customer Interaction and User Experience

Investment Week Sustainable and ESG Investment Awards 2018

Shortlisted: Best New Entrant - Services

Citywire Investment Performance Awards 2018

Shortlisted: Best Medium Firm

Investment Week Fund Services Awards 2018

Shortlisted: Best Technology Solution (small to medium firm)

FE Trustnet Alpha Manager Ratings 2018

Winners: David Absolon, Scott Ingham, Michael Stanes

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Past performance is not a reliable indicator of future results.